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2 The Role of Taxation in the Development of East Asian Economies

Vito Tanzi and Parthasarathi Shome

2.1 Introduction

This paper examines the role that taxation has played in the economic development of eight East Asian economies—Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan Province of China (henceforth, referred to as Taiwan), and Thailand. These include four so-called newly industrialized countries (Hong Kong, Korea, Singapore, and Taiwan), two oil exporters (Indonesia and Malaysia), and the Philippines and Thailand.[1] Much has been written on the tax systems of these countries, but a perusal of the literature indicates that it is difficult to identify the role that taxation has played in the development of these economies.[2] Indeed, the papers tend to focus more on the need to reform the existing tax systems than on the role that these systems may have played.

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1. In this paper, the term *country* is used synonymously with *economy.* No legal significance should be attached to the use of this term.

2. For comparative studies, see Shome (1986). The most exhaustive set of recent papers was presented at a January 1990 symposium, "Tax Policy and Economic Development among Pacific Asian Countries," Institute for Social Sciences and Philosophy, Taipei. Of particular interest were the papers by Asher, Salih, and Salleh (Malaysia); Gillis (Indonesia); Kim and Lee (Korea); Lee (Korea); Richupan (Thailand); and Sicat (the Philippines). A February 1990 conference, "Fiscal System of Singapore: Trends, Issues, and Future Directions," offers another interesting set of papers, of particular relevance being Asher's paper on the fiscal system in an international perspective. See also Riew (1988) on Taiwan, and Asher (1989) on all the sample countries, including Hong Kong.

This paper has two distinct parts. Section 2.2 provides an informal summary of the main features of the tax systems of these countries that may have played a role in their economic development, with the objective of highlighting the major differences among the countries. In a way, this part looks at the past experiences of these countries to see whether any conclusions can be derived from them. Section 2.2 also includes a more forward-looking part that, after commenting on recent changes, assesses the direction that tax reform should take to increase the usefulness of the tax system as an instrument for development. Section 2.3 is a more speculative section that attempts to draw some lessons and some conclusions from the experiences of these countries.

2.2 Tax Structures, Tax Reform, and the Development of East Asian Economies

This section highlights some characteristics of the tax structures in the various sample countries, as well as major features of recent tax reform that might have helped or hindered their economic development. We will deal with three subgroups: (1) the newly industrialized countries (NICs);[3] (2) the two oil exporters; and (3) Thailand and the Philippines. Tables 2.1 and 2.2 will be used for reference.

2.2.1 Taiwan

General Characteristics

Taiwan's development strategy has been characterized by (1) a high saving rate, matched by appropriate interest rate policies; (2) an export orientation, supported by an appropriate exchange rate policy and by rapid industrialization financed by the high saving rate; and (3) an awareness of equity considerations as revealed by its land reform program, by the system of property taxation, and by the fact that this is the only country that seems to have generated official annual surveys of income distribution.

Having grown to about 20 percent in the early 1980s, the tax/GDP ratio fell back to about 15 percent by the late 1980s; such a level is now well below the world average especially for countries at Taiwan's level of economic development. Nevertheless, given the limited range of activities by the public sector and good public expenditure management, public revenue has been sufficient to meet the country's expenditure needs. Fiscal deficits were not allowed to develop, and revenue generation, per se, never became a major concern of the tax system. Thus, Taiwan did not experience the fiscally caused macroeconomic problems that have characterized many other countries.

Subnational taxes are important revenue sources, accounting for 45 percent

3. For a comprehensive analysis of the increasing economic maturity of the four NICs, see Banque Indosuez (1990).

Table 2.1 **Sample Asian Countries: Tax Revenue by Type of Tax (in percentage of total tax revenue)**

	Total Taxes	Income Taxes				Domestic Taxes on Good and Services				Foreign Trade				Social Security	Wealth and Property	Other
		Total	Individual	Corporate	Other	Total	General Sales, Turnover, VAT	Excises	Other	Total	Import Duties	Export Duties	Other			
Taiwan (1988)[a]	100	22.0	10.8	11.2	. . .	35.5	13.0	11.0	11.5	14.1	14.1	—	—	—	21.4	7.0
Hong Kong (1987)[a]	100	54.5	26.7	27.8	. . .	25.1	. . .	. . .	. . .	9.8	9.8	—	—	—	10.6	. . .
Korea (1986–88)	100	31.3	17.1	14.2	—	44.3	22.0	13.7	8.7	17.2	17.2	—	—	2.6	1.3	2.2
Singapore (1985–87)	100	42.9	15.1[b]	27.8[b]	. . .	27.5	—	9.0	18.5	6.1	6.1	—	—	—	17.1	6.5
Malaysia (1986–88)	100	48.7	12.8	35.8	0.1	24.4	7.9	9.5	7.0	23.2	14.4	8.8	—	1.0	0.6	2.2
Indonesia (1986–88)	100	61.0	4.6	55.0	1.3	28.2	19.5	6.5	2.3	8.0	6.0	0.6	—	—	1.6	0.9
Thailand (1986–88)	100	21.6	11.1	10.5	—	53.2	19.0	29.6	4.7	22.6	21.3	1.2	0.2	—	1.7	0.8
Philippines (1985–87)	100	28.0	9.0	14.3	4.7	44.0	10.0	24.8	9.3	25.2	23.1	0.9	1.2	—	0.7	2.1

Sources: International Monetary Fund; Asher (1900) for Taiwan and Hong Kong.

[a]The composition of the various taxes should be used as broad indicators.

[b]Assumed proportions from Asher (1990).

Table 2.2 Sample Asian Economies: Selected Tax Characteristics

	Taiwan	Hong Kong	Korea	Singapore	Indonesia	Malaysia	Thailand	Philippines
Maximum corporate income tax rate (%)	25	16.5	33[a]	33	35	40	35	35
Maximum personal income tax rate (%)	40[b]	15	50[a]	33	35	40	55	35
Treatment of capital gains[c]	S	E	S	E	S	E	S	S
Withholding taxes								
Dividend	20	—	10	—	20	—	20	35
Interest	20	—	10	33	20	20	25	20
Tax incentives	Important	Small	Important	Important	None	Important	Important	Important
Basic sales tax/VAT rate	5	None	10	None	0–35	5–10	0.5–10	10
Property taxes	High	Based on rent	Low	High	Low	None	Low	Low

Sources: MIER 1989, and updated information from national sources.

[a]If defense and inheritance surcharges are included, the effective corporate tax rate would be 42 percent and the top personal income tax rate would be 64 percent.

[b]Reduced from 50 percent in 1990.

[c]*S* = same as ordinary income; *E* = exempt.

of total tax revenue. They have strong implications for intragovernmental transfers; thus, studies on the Taiwanese tax system have tended to analyze both national and regional taxes (Riew 1988; Asher 1989). Of the tax composition presented in table 2.1, the national government collects customs duties, selected commodity taxes, personal income tax, and business income tax—there is no payroll tax—while the subnational governments levy monopoly charges on tobacco and wine (10 percent, of which the national government gets the lion's share at 6.5 percent), land-related taxes, and a flat 5 percent value-added tax, called the business tax.

Role of Selected Important Characteristics of Tax Policy

Incentives to Save and Invest. The fact that income taxes have not contributed significantly to tax revenue reflects the tax incentives given through the income tax system. Until 1981, there was an unlimited exclusion of both interest and dividend earnings from personal income taxation, at which time a ceiling was imposed (beyond which they would be taxed at a flat rate). Capital gains were exempt until 1989 (when a threshold was introduced that affects only large investors), thereby increasing the effective after-tax rate of return on capital. Expenditure allowances are relatively small, with no deductibility of interest on consumer loans and limited deductibility on mortgage loans.

It has been argued that such incentives to save and invest coupled with a lack of any tax-induced encouragement to spend have had a significant impact on the high savings performance of the economy; they also have helped to expand the corporate sector and to develop the capital market.

Investment incentives are also provided within the Statute for Promoting Investment (SPI), which applies to a wide range of "productive" enterprises[4] that are liable to the business income tax. Under the SPI, all research and development expenditures are immediately deductible. A five-year tax holiday or accelerated depreciation is provided for new and expanding enterprises, with additional preferences for "capital or technology-intensive" enterprises, together with a 20 percent effective tax rate ceiling (including surcharges) on "important" enterprises in basic metals, heavy machinery, and petrochemicals, and an additional tax credit worth 5–20 percent of investment in capital stock in "strategic" enterprises as determined by the government. Finally, mergers are encouraged by exempting the dissolved enterprise and providing a two-year, 15 percent tax credit to the merged enterprise. In sum, Taiwan has had a very finely tuned tax incentives scheme with the objective of rapid industrialization.

Land-based Taxes. Perhaps the most distinguishing feature of Taiwan's tax structure among the sample countries has been its ability to tap property val-

4. Most profit-seeking enterprises except those in trade, banking, and services.

ues—land as well as structures—as a significant source of revenue, a characteristic shared with Singapore. There are three main taxes: the land value tax (LVT), the land value increment tax (LVIT), and the house tax. Without going into the details of the individual tax structures, suffice it to say that the LVT is comparable to the property taxes of most other countries, that is, it is based on the assessed value of residential and industrial urban land. As might not be too surprising, its share in tax revenue has declined over time—from 4 percent in 1980 to 2 percent in 1987. Neither does the house tax, which is levied on the value of construction, generate much in terms of revenue.

The uniqueness lies in Taiwan's successful implementation of the LVIT on the *net increment to the transfer value* of land, levied at the rate of 40 percent on the first 100 percent increase, 50 percent on the next 100 percent, and a top rate of 60 percent. This is a kind of benefit-received tax, since the increase in the land value is assumed to reflect the growth of the economy and the provision of public services. Land is probably the main beneficiary of public spending on infrastructures. Apart from being a significant revenue generator, the tax is likely to have contained land speculation, raised regional autonomy, and improved the equity of the tax system.

In a country where income tax revenue is not high (in contrast to Hong Kong and Singapore), a relatively high contribution from property taxes has maintained the level of public revenue at an adequate level in spite of the granting of wide-ranging incentives from the income tax base. In a way, the land taxes have paid for the investment incentives. Also, in an environment of high savings and large trade surpluses there could be an incentive toward speculative investments, especially in the form of landholdings. LVIT discourages such investments and redirects financial resources toward more productive investments for which tax incentives are given.

The LVIT has been a much-needed instrument to counter the probable negative effect on the income distribution of the various savings incentives, the relatively small capital gains tax, and the special incentives for capital-intensive investment. The growth of LVIT revenues implies a rising share of subnational tax revenue in overall tax revenue and, consequently, a greater decentralization of the fiscal sector, bringing with it a more balanced regional development.

Customs Duties. In the early stages of development, customs duties usually account for a major share of tax revenue. This was the case in Taiwan. If growth and development proceed on the right path, the advantages of an open economy eventually become more apparent, thus leading to a decline in the share of customs duties. This has occurred in Taiwan; however, one is surprised that, in spite of its success as an international competitor, customs duties still remain important—their tax share declining rather slowly, from 24 percent in 1975 to 22 percent in 1980.

Tax Reform for Development

Strongly relying on a system of tax incentives to promote industry-led exports, Taiwan has felt the need neither to globalize income taxes nor to curtail significantly its incentives structures. This is not to say that it completely overlooked the need for tax reform or that it did not initiate some reforms. Reform measures were taken in 1986 when the value-added tax (VAT) was introduced and the top marginal personal income tax rate was reduced from 60 percent to 50 percent; in 1988 when the top business income tax rate was reduced from 35 percent to 25 percent; and in 1990 when the top personal income tax rate was reduced further to 40 percent. Thus direct taxes followed the international trend toward the lowering of marginal tax rates.

The most important reform action was perhaps the introduction of the consumption-based VAT with the dual objectives of reducing the distortions created by the existing commodity taxes and, as an added incentive to export, eliminating exports and capital goods from the tax base. Revenue generation was not an objective, and the VAT was introduced on a revenue-neutral basis at a single 5 percent rate. Therefore, while the schedular direct tax structure together with its multifaceted incentives schemes is still considered important to promote growth, the multirated commodity taxes were perceived as distortionary and were replaced by a VAT.

Taiwan has not had fiscal deficits; its direct tax and incentives system seems geared for its industry-led, export-oriented growth path that has certainly materialized; it has substituted the reduced role of direct taxes with increased land taxation; it has substituted a generalized VAT for distortionary domestic consumption taxes; and in answer to a large trade surplus, it has been reducing its customs tariffs (even though they still remain high). On the face of it, thus, taxation may have played a positive role in Taiwan's development. The tax structure that accompanied that growth reflected the philosophy of the 1960s and 1970s based on fine-tuning tax incentives and disincentives. Taiwan shows no particular inclination to move away from it and, given the success of its economy, it is easy to understand why.

There are some aspects of taxation that Taiwan probably cannot neglect in the future as its economy matures and enters the next stage of development. First, the complete absence of payroll/social security taxation will need to be replaced by some form of contribution system that addresses the issue of social insurance and social security. Second, pollution taxes will possibly have to be introduced to ameliorate environmental deterioration. Third, the levels of customs tariffs will have to be reduced, especially in view of Taiwan's large trade surplus. Finally, the large trade surplus may lead to strong reactions by other countries and force Taiwan to reassess its incentive policy toward exports.

2.2.2 Hong Kong

General Characteristics

Among the sample countries, Hong Kong's average tax level has been the smallest (together with the Philippines), though the tax/GDP ratio increased from around 9 percent in 1975 to 10 percent in 1980 and reached almost 12 percent by 1987 (Ho 1989). Revenues have been sufficient to meet public expenditure so that revenue generation has not been an objective requiring particular attention. The relative importance of direct taxes in total tax revenues has risen from the 52–54 percent range in 1974–76 to the 55–59 percent range in 1985–87.

Selected Distinguishing Features

Aspects relevant to development are the low tax level and the resilience of the tax structure itself. The main tax—the earnings and profits tax (EPT)—has remained basically unchanged since the mid-1950s, thereby imparting a stable tax environment for business operations. This has removed an important factor—tax uncertainty—that in other countries plays a role in reducing the incentive to invest.

Overall Tax Levels. The "standard" tax rate and the corporate tax rate of the EPT are low and result in low overall tax levels. Between 1975 and 1984, the standard tax rate was 15 percent; it rose to 17 percent in 1986 but was steadily brought back to 15 percent by 1989. Similar modifications apply to the corporate tax, the corresponding rates being 16.5 percent, 18.5 percent, and 16.5 percent. As a consequence of these low rates, the authorities have felt no need to grant tax incentives. However, depreciation allowances are quite liberal with high initial allowances, inventory valuation is on market-value basis, the nominal value of interest payments is deductible, and losses can be carried forward for an indefinite period of time. There are no taxes on dividends or capital gains, even at the personal level, and a tax on interest income was eliminated in 1989.

Indirect taxes are not high either. Import duties and excises which tend to be levied on a specific basis—resulting in low elasticities with respect to GDP growth—have fallen in terms of GDP from around 2 percent in 1970 to 1.5 percent in the mid-1970s and 1 percent in 1986. The dutiable commodities are few and include tobacco, alcoholic and nonalcoholic beverages, cosmetics, and hydrocarbon oils. Other indirect taxes are also selective and are levied on usually accepted sumptuary bases—bets and sweeps tax, entertainment tax, hotel accommodation tax, stamp duties, airport departure and harbor passage tax, and motor vehicles tax. In sum, the role of tax policy in the development strategy of Hong Kong has consisted in maintaining an environment of low interference with private sector activity matched by neutrality made possible

by a policy of low government expenditure and taxation. It is not difficult to see why Hong Kong has been seen as the best example of a supply-side–oriented fiscal policy.

Resilience of the Tax Structure. Hong Kong's tax structure has remained relatively unchanged since the 1950s. The EPT, its direct tax umbrella, is a schedular system comprising salaries (after various forms of personal allowances), profits (both noncorporate and corporate), property (only rent is taxed), and interest (abolished in 1989). Different tax rates apply to each component. The fact that the bases remained more or less unchanged while the rates changed very little and remained very low by international standards over three decades is possibly the most important distinguishing feature of Hong Kong's tax system. If the tax system played a role in attracting and maintaining a high level of investment and in promoting growth, it must have been due to that feature.

Tax Reform

In its continuous endeavor to encourage efficiency and growth Hong Kong introduced a major change in its tax structure in 1989 by abolishing its tax on interest income, thus equating it, for tax purposes, to the untaxed dividends and capital gains. To a large extent, therefore, the tax base moved closer to consumption.

Hong Kong's main preoccupation for its future development is its tax structure after 1997. Several authors have suggested possible tax reforms in view of the forthcoming change. Asher (1989) has recommended increasing the base of indirect taxes rather than raising EPT rates at a time when the economy might be expected to undergo a recession. The 1988 Budget Speech also recommends a sales tax in the medium term. The Draft Basic Law for after 1997 emphasizes the continuation of a free port, low taxation, and balanced budgets. A related concern is the possible extension to Hong Kong of China's tax treaties with third countries.

To conclude, Hong Kong's future development comprises unique challenges. While its tax structure has remained viable for many years, the emerging circumstances are likely to oblige Hong Kong to introduce major modifications. Some of these modifications would inevitably raise the tax level. It must be recalled that the tax level of China is now about 20 percent of its GDP. It does not seem likely that Hong Kong would have the luxury of maintaining its present unusually low ratio.

2.2.3 Korea

Structural Characteristics

Korea's history of rapid GDP growth begs the question as to whether and to what extent that growth was supported by its tax policies. A glance at Ko-

rea's tax shares indicates that taxes on domestic goods and services yield almost half of total tax revenue, income taxes less than a third, and customs duties almost a fifth. Social security and property taxes contribute little. Tax shares have remained more or less stable since the mid-1970s in the face of various tax reforms.

Korea's tax structure has been changed many times since the 1960s in order to raise the elasticity of the tax system by increasing the share of broad-based, domestic indirect taxes and in order to promote specific objectives. This change accompanied the reduction in foreign trade taxes and the granting of wide-ranging tax incentives from corporate income taxes. The objective was the promotion of export-oriented industrialization—a strategy similar to that of Taiwan.[5] By contrast personal incomes continued to be taxed at high rates (the 70 percent top marginal rate, which was reduced only in 1989, was not only the highest in our sample, but was high by world standards—see table 2.2—and continues to be one of the highest in our sample). Furthermore, it yielded about a sixth of tax revenues (table 2.1)—the second highest proportion within the sample (after Hong Kong).

Selected Distinguishing Features

Among the distinguishing features of Korea's tax system are (1) the earliest introduction—among the sample countries—of a VAT in 1977; (2) the strong role given to tax incentives; (3) an early recognition of the important role of tax administration in revenue performance; and (4) a tax reform process that has been almost uninterrupted over the years as a part of what seems to be a policy of perennial fine tuning of the tax system to promote specific objectives. These aspects are discussed below.

The VAT has become the single largest contributor—at well over a fifth—to total tax revenue and has functioned remarkably well with little change since its introduction in 1977. It is levied at a single rate of 10 percent and generates over 4 percent of GDP, which is a very good yield for such a low rate. By providing the needed revenue, Korea's early introduction of the VAT enabled the country to grant generous tax incentives geared toward its industrialization and export strategy. In this sense, Korea's VAT played a similar accommodative role as Taiwan's land-based taxes.

Until recently tax incentives had been assumed to have played an important role in Korea's economic development. Embodied in the Tax Exemption and Reduction Control Law (TERCL), they include investment tax credits, special depreciation, tax-free reserves, and liberal expensing from taxable income, in addition to the usual deductions. On the other hand, the rules for foreign direct investment have always been restrictive. Until the mid-1980s, foreign investment was allowed only for "beneficial" activities. Thus, even with a doubling of "arrived" direct foreign investment of U.S. $477 million in 1986 from $236 million in 1985, and reaching $626 million and $894 million in

5. Many incentives were aimed at increasing exports. See Kwack (1990).

1987 and 1988, respectively, it still represents only around 3 percent of GDP. The uniqueness of Korea's tax incentives policy, therefore lies in its being tailored toward domestic industrial development, exports, and technology transfer, rather than toward foreign investment.

Recently several Korean studies have begun to question both the effectiveness of those incentives and their equity implications. Several authors have concluded that these tax incentives have been overgenerous, leading to unnecessary revenue loss[6] and have led to inequities (Kim and Lee 1990; Kwack 1990). Lee (1990) strongly condemns the growth-orientation of the economy at a cost to a more balanced development path that would accommodate social objectives. He is of the opinion that "Korea's fiscal policy has played a weak and passive role and thus failed to fulfill necessary social needs" (3). He supports his argument with an international comparison of income distribution.[7] Now that Korea—like Taiwan—has emerged as a "growth tiger," it is beginning to give increasing weight to the objective of equitable income distribution, an objective that had not received a lot of attention in the past. Of course, the overall standard of living of Koreans has improved enormously with the achievement of sustained high rates of growth.

Among the sample countries, Korea may have been the forerunner in recognizing the importance of tax administration. The Office of National Tax Administration (ONTA), created in 1966, appears to have been quite successful in raising the tax/GDP ratio by 4 percentage points between 1966 and 1970. This office has carried a lot of power over the years. Indeed, some researchers are of the opinion that the role of tax administration has been more important than that of tax policy in determining Korea's revenue performance over the past three decades. However, several Korean participants at this conference commented on the increasing incidence of tax evasion and avoidance in Korea in recent years, thereby exacerbating the adverse distributional consequences of the tax system.

Tax Reform

A quotation pertaining to Korea from Asher (1989, 54) seems appropriate: "Tax reform is almost continuous. Major tax reforms were undertaken in 9 out of the 33 years between 1953 and 1986. Choi and Lee (1987) also report that in 7 of those 9 years, the changes were substantial enough to be labeled 'comprehensive.'" Tax policy changes have continued since 1986 with reduction in the top personal income tax rate and in the number of brackets, together with greater relief to lower brackets and wider globalization in the tax structure.

Despite the above changes, the greatest pressure on Korea's future tax re-

6. It should be noted that the corporate tax generated only a little more than 2 percent of GDP in 1986–88. Unpublished data indicate that in 1980 tax incentives reduced the corporate income tax base by two-thirds.

7. Kwack's conclusion is that "the tax incentives to promote exports have played only minor roles in Korea's export-oriented development process" (1990, 18).

form reflects its heightened concern toward income redistribution (Sixth Five-Year Plan, 1987–91). Such a concern will inevitably be reflected in higher social spending and in higher taxes. First, to provide nationwide medical insurance and a pension scheme, the payroll tax is slated for increase. Second, a punitive tax on the increased value of land (similar to Taiwan's LVIT) is planned in order to curb speculative forces as well as for reasons of equity. Speculators holding land zoned for housing development will pay a 50 percent tax on the increase in the annual value of the land; urban property in excess of 700 square meters will face high tax rates; and the rating system will be revised to reflect property values rather than the building cost. This is to directly redress to some extent the adverse situation of 70 percent of families in major urban areas that do not own any property. Third, currently allowable false-name stock accounts will be transformed to real-name accounts and made subject to capital gains tax. Similarly, in anticipation of a more advanced society, authors have also cited the need that "fiscal policy should be geared toward establishing medium- and long-term antipollution measures" (Lee 1990, 14).

Korea has extensively used tariff and nontariff barriers to control imports, though with a steady relaxation over recent years that has brought down the average tariff rate. With a burgeoning trade surplus a quicker liberalization of trade would be desirable—as in Taiwan. Interestingly, trade liberalization, so far, has apparently allowed greater luxury imports and, therefore, a notion of ostentatious consumption and at least a perception of increased inequities. Large differences in consumption patterns seem less socially acceptable than large differences in incomes. As a consequence the issue of income distribution has been brought to the forefront. Also, the benefits from export incentives are being questioned. It is likely that these incentives will be reduced if not eliminated in future years.

2.2.4 Singapore

Structural Characteristics

Singapore is the fourth of the sample economies that selected a development strategy based primarily on advanced technology and oriented toward exports. Public revenues have been adequate to meet its expenditure needs; thus revenue increase has not been an explicit concern of tax policy. Instead, tax incentives, fine-tuned for the purpose of generating rapid growth in selected sectors, have played as important a role in Singapore's tax policy as they were intended to play in Taiwan and Korea.

Yet Singapore, like Hong Kong but unlike Taiwan, has continued to draw a major share of its tax revenue—40–45 percent—from income taxes, and two-thirds of this share from the corporate tax. On the other hand, like Taiwan but unlike Hong Kong, it relies relatively heavily on property taxes, which account for 17 percent of tax revenue. Given its relatively heavy reliance on

both income and property taxes, the contribution of customs duties and consumption taxes has been limited—about a third of total tax revenue.

Selected Distinguishing Features

Among the distinguishing features of Singapore's tax system is the large number of personal income tax brackets. Thus, Singapore has not followed the current trend toward broad, low-rate taxation with few brackets. Singapore has aimed at as broad a participation as possible by potential taxpayers in an effort to raise their tax consciousness. In 1987, for example, about two-thirds of the taxpayers had assessed income of below S. $15,000 and accounted for only 8 percent of the tax assessed (Asher 1990, 15).

Possibly the most striking feature of Singapore, a feature that sets it apart from the other countries in the sample, is its interventionist policy affecting social security provision. Provident fund contributions that amount to about a third of gross wages, including employer contributions, are tax-exempt. While this narrows the tax base, Singapore's social security needs are being met through a funded rather than a pay-as-you-go principle of social insurance and without resorting to financing through budgetary sources. As Singapore grows into an industrialized economy, the same questions being asked in Korea and Taiwan are being raised in Singapore: Should the government expand its role in providing social insurance through the budget? Does the government have responsibility in this regard as the nation matures? What should not be overlooked, however, is the past management by government in the successful provision of housing to the majority of the population through loans drawn on the Central Provident Fund, an achievement not claimed by Taiwan, Korea, and Hong Kong.

Singapore is not different from Taiwan or Korea in its explicit and forceful use of income tax incentives for promoting industrial policies. As mentioned above, it has used them also as an instrument for its social policies (i.e., deductions of provident fund contributions) as well as for the retention of local and foreign professional work forces. Like Hong Kong, Singapore has used tax incentives to promote its financial policies by exempting capital gains from taxation altogether.

Tax Reform

As Singapore matures further, what role can taxation be expected to play? Perhaps Singapore should move toward a uniform, broader-based system of taxation. While the 1986 Report of the Economic Committee of the Ministry of Trade and Industry recommended phasing out selective fiscal incentives and moving to a uniform, low corporate and personal income tax structure as a long-term goal—a move that would take Singapore in the direction of Hong Kong—it also called for additional incentives in the immediate future, for example, a 30 percent initial allowance for all investment (this would, of course, remove the current promanufacturing bias of tax incentives). Thus, as

in Taiwan, Singapore has not effectively questioned the continued role of tax incentives in the near term.

Similarly, while the share of revenue from domestic consumption taxes has increased in the late 1980s, interest in a broad-based VAT remains slight, especially in an environment in which neither private savings nor overall tax revenue are considered low, though Singapore has been studying the advantages of eventually introducing a VAT. In any case, the economy of Singapore is, perhaps, organized enough to render feasible a retail sales tax instead of a VAT.

The primary area where Singapore could seriously consider tax reform, at its present stage of development, is in a reintroduction of the payroll tax for the budgetary financing of social insurance. The Economic Committee's recommendation for a property tax decrease, effective in 1990, would also have a revenue impact and would possibly require some fine-tuning in other tax revenue sources.

2.2.5 Malaysia

Structural Characteristics

Malaysia is the first of the non-NICs in our sample, and its tax history exhibits their common concern regarding revenue generation. Like Indonesia, it is a petroleum exporter and has had a similar problem of trying to raise the share of nonpetroleum revenues in the presence of present or expected reduction in oil revenues. It has experienced large fiscal deficits throughout the 1980s and has accumulated considerable foreign debt. Table 2.3 presents, for available sample countries, the movements over time of tax/GDP ratios. It shows how in the 1980s Malaysia's tax/GDP ratio fell steadily, with the relative decline in nonoil tax revenue being even greater. This fall in revenue has forced a large reduction in public spending in recent years.

Various causes may be cited for the decline in revenue. First, tax incentives have grown to include "investment, export, reinvestment, research and development, labor utilization, manpower training, location, and others" (Asher, Salih, and Salleh 1990, 11). The inevitable result has been a fall in the corporate income tax/GDP ratio. Second, despite a doubling of the sales tax rate from 5 percent to 10 percent in 1983, revenue from this tax has declined slightly in terms of GDP as a result of the progressive erosion of the tax base.[8] Similarly, the excise tax/GDP ratio has stagnated because many of the taxed items have been removed, leaving only traditional excisable items—petroleum, tobacco, alcohol, and motor vehicles. Third, taxes on exports have declined by about 3 percentage points of GDP between 1978 and 1988, while customs duties have declined by 1 percentage point. Finally, despite the use

8. The Malaysian Institute of Economic Research (MIER) has estimated that, up to 1987, 75 percent of domestic manufacturing output was exempt from the tax base. Some of the exemptions were reduced in 1988.

Table 2.3 **Tax GDP Ratio of Sample Asian Countries (time series)**

	1978–80	1979–81	1980–82	1981–83	1982–84	1983–85	1984–86	1985–87	1986–88
					Total Tax Revenue				
Singapore	16.81	17.51	18.56	19.20	19.17	18.10	16.16	14.75	13.90
Korea	15.39	15.49	15.56	15.72	15.64	15.40	15.03	15.10	15.53
Malaysia	21.69	22.19	22.46	22.24	21.84	22.28	21.89	20.20	18.27
Thailand	12.42	12.73	12.91	13.44	13.87	14.29	14.22	14.24	14.74
Philippines	11.66	11.25	10.58	10.18	9.83	9.85	9.90	10.86	11.30
Indonesia	19.99	20.82	20.44	19.13	17.99	17.72	16.64	16.03	15.04
					Taxes on Income				
Singapore	7.48	8.15	9.25	9.73	9.50	8.59	7.26	6.35	5.79
Korea	4.22	4.16	4.14	4.18	4.12	4.11	4.16	4.48	4.87
Malaysia	8.72	9.30	9.88	10.06	10.03	10.59	11.03	10.22	8.98
Thailand	2.45	2.56	2.73	2.89	3.04	3.15	3.26	3.16	3.18
Philippines	2.81	2.69	2.55	2.40	2.31	2.50	2.76	3.02	3.04
Indonesia	15.48	16.92	16.93	15.87	14.82	14.19	12.09	10.58	9.17
					Individual Income Taxes				
Singapore	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Korea	2.16	2.14	2.14	2.21	2.18	2.19	2.26	2.44	2.66
Malaysia	2.11	2.05	1.97	2.22	2.42	2.44	2.40	2.33	2.31
Thailand	1.07	1.08	1.17	1.33	1.54	1.71	1.80	1.73	1.63
Philippines	1.52	1.35	1.23	1.13	0.97	0.91	0.89	0.97	1.00
Indonesia	0.45	0.39	0.39	0.44	0.49	0.57	0.61	0.65	0.69
					Corporate Taxes				
Singapore	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Korea	2.05	2.02	1.99	1.97	1.94	1.92	1.91	2.04	2.21
Malaysia	6.61	7.24	7.91	7.84	7.62	8.15	8.61	7.88	6.66
Thailand	1.38	1.48	1.55	1.56	1.50	1.44	1.46	1.43	1.55
Philippines	1.30	1.36	1.35	1.29	1.31	1.38	1.41	1.55	1.56
Indonesia	14.06	15.61	15.58	14.52	13.62	13.18	11.22	9.68	8.28
					Taxes on Income—Other				
Singapore	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Korea	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Malaysia	0.01	0.00	0.00	0.00	0.00	0.00	0.01	0.02	0.02
Thailand	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Philippines	0.00	0.00	0.00	0.00	0.04	0.22	0.45	0.50	0.49
Indonesia	0.96	0.92	0.96	0.91	0.70	0.44	0.26	0.25	0.20
					Domestic Taxes on Goods and Services				
Singapore	3.91	3.90	3.87	3.87	3.97	3.93	3.86	4.02	4.12
Korea	7.62	7.89	8.08	8.09	8.00	7.76	7.42	7.08	6.87
Malaysia	4.65	4.38	4.32	4.61	4.79	4.94	4.78	4.59	4.43
Thailand	6.20	6.40	6.60	7.10	7.32	7.46	7.39	7.62	7.84
Philippines	5.35	5.34	4.93	4.61	4.21	4.06	4.24	4.78	5.14
Indonesia	2.22	1.96	1.99	2.02	2.05	2.46	3.39	3.94	4.23

(*continued*)

Table 2.3 (Continued)

	1978–80	1979–81	1980–82	1981–83	1982–84	1983–85	1984–86	1985–87	1986–88
				Taxes on General Sales, Turnover, VAT					
Singapore	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Korea	3.60	3.71	3.84	3.89	3.86	3.77	3.60	3.49	3.41
Malaysia	1.23	1.25	1.28	1.46	1.59	1.70	1.55	1.45	1.43
Thailand	2.67	2.63	2.64	2.69	2.81	2.88	2.85	2.71	2.81
Philippines	1.79	1.72	1.65	1.56	1.29	1.06	0.97	1.08	1.19
Indonesia	1.19	0.99	1.02	1.04	1.06	1.48	2.07	2.65	2.93
				Taxes on Excises					
Singapore	1.47	1.41	1.36	1.37	1.47	1.53	1.47	1.33	1.22
Korea	2.63	2.67	2.55	2.44	2.36	2.32	2.28	2.16	2.11
Malaysia	2.09	1.86	1.71	1.75	1.81	1.85	1.86	1.79	1.73
Thailand	2.56	2.85	3.16	3.57	3.78	3.86	3.92	4.23	4.34
Philippines	2.75	2.60	2.27	2.06	1.99	2.11	2.34	2.70	2.90
Indonesia	1.03	0.97	0.96	0.98	0.99	0.98	0.99	0.96	0.97
				Domestic Taxes on Goods and Services—Other					
Singapore	2.44	2.49	2.51	2.50	2.50	2.40	2.39	2.69	2.90
Korea	1.39	1.51	1.69	1.77	1.78	1.66	1.54	1.42	1.34
Malaysia	1.34	1.27	1.32	1.40	1.39	1.39	1.36	1.35	1.27
Thailand	0.97	0.92	0.80	0.83	0.73	0.72	0.62	0.68	0.68
Philippines	0.81	1.01	1.01	1.00	0.93	0.90	0.93	1.00	1.04
Indonesia	0.00	0.00	0.00	0.00	0.00	0.00	0.33	0.33	0.33
				Taxes on Foreign Trade					
Singapore	1.86	1.71	1.57	1.45	1.40	1.24	1.05	0.89	0.84
Korea	2.92	2.69	2.53	2.58	2.63	2.62	2.52	2.63	2.67
Malaysia	7.83	7.96	7.63	6.87	6.29	6.01	5.38	4.70	4.20
Thailand	3.49	3.51	3.32	3.18	3.21	3.36	3.27	3.15	3.35
Philippines	3.11	2.92	2.78	2.80	2.97	2.97	2.63	2.75	2.80
Indonesia	1.96	1.67	1.26	0.99	0.84	0.74	0.79	1.11	1.21
				Taxes on Imports					
Singapore	1.86	1.71	1.57	1.45	1.40	1.24	1.05	0.89	0.84
Korea	2.92	2.69	2.53	2.58	2.63	2.62	2.52	2.63	2.67
Malaysia	3.56	3.68	3.83	3.77	3.60	3.45	3.18	2.85	2.61
Thailand	2.92	2.84	2.66	2.67	2.79	2.99	2.98	2.92	3.15
Philippines	2.86	2.71	2.65	2.70	2.77	2.66	2.29	2.54	2.70
Indonesia	1.09	0.97	0.91	0.82	0.71	0.64	0.72	0.78	0.90
				Taxes on Exports					
Singapore	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Korea	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Malaysia	4.28	4.28	3.80	3.10	2.69	2.57	2.20	1.85	1.58
Thailand	0.58	0.67	0.66	0.51	0.41	0.34	0.25	0.20	0.17
Philippines	0.25	0.20	0.12	0.09	0.16	0.18	0.20	0.09	0.05
Indonesia	0.87	0.70	0.34	0.16	0.12	0.10	0.08	0.06	0.09

(*continued*)

Table 2.3 **(Continued)**

	1978–80	1979–81	1980–82	1981–83	1982–84	1983–85	1984–86	1985–87	1986–88
				Taxes on Foreign Trade—Other					
Singapore	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Korea	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Malaysia	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Thailand	0.00	0.00	0.00	0.00	0.01	0.03	0.04	0.03	0.03
Philippines	0.01	0.01	0.02	0.01	0.04	0.13	0.14	0.12	0.05
Indonesia	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
				Social Security Contribution					
Singapore	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Korea	0.18	0.19	0.19	0.20	0.21	0.23	0.25	0.27	0.41
Malaysia	0.10	0.11	0.13	0.14	0.14	0.14	0.16	0.18	0.18
Thailand	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Philippines	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Indonesia	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
				Taxes on Wealth and Property					
Singapore	2.96	3.00	3.05	3.29	3.51	3.53	3.10	2.54	2.15
Korea	0.08	0.11	0.15	0.17	0.16	0.13	0.11	0.12	0.20
Malaysia	0.10	0.12	0.14	0.15	0.14	0.12	0.12	0.11	0.10
Thailand	0.18	0.18	0.17	0.19	0.20	0.21	0.20	0.20	0.25
Philippines	0.16	0.10	0.10	0.10	0.09	0.09	0.08	0.07	0.07
Indonesia	0.24	0.20	0.19	0.18	0.19	0.21	0.21	0.21	0.24
				Other Taxes					
Singapore	0.60	0.75	0.83	0.86	0.79	0.81	0.89	0.95	1.00
Korea	0.37	0.43	0.47	0.50	0.51	0.55	0.41	0.36	0.35
Malaysia	0.28	0.32	0.37	0.41	0.45	0.46	0.43	0.40	0.39
Thailand	0.09	0.09	0.08	0.09	0.10	0.11	0.11	0.11	0.12
Philippines	0.18	0.20	0.21	0.21	0.20	0.19	0.21	0.23	0.25
Indonesia	0.07	0.06	0.06	0.06	0.06	0.08	0.10	0.10	0.14

Source: Fiscal Affairs Department data base, International Monetary Fund.

of various individual income surtaxes, such as a 5 percent development tax on professional, business, and rental income, as well as a 5 percent excess profits tax, individual income tax in relation to GDP has also declined. Thus, other smaller tax sources and petroleum revenue have increased relative to GDP. Malaysia has been studying the possibility of introducing a VAT at some point. But no decision has yet been made in this direction.

Selected Aspects

In 1986, a 1968 law on tax incentives was replaced by the Promotion of Investment Act on the grounds that the earlier system was difficult to administer, favored capital-intensive and large projects, was too generous, and granted unnecessary protection to domestic industry. However, the incentives

do not appear to have been greater than those granted by the NICs. The revised Malaysian act itself, as well as the Malaysia Institute of Economic Research (MIER) tax reform proposals, does not really attempt to reduce the role of tax incentives; MIER, for example, recommends their extension to the service sector and high-risk projects, as well as the widening of their range.

More than the complexity of the incentives themselves, the impact of petroleum as a source of revenue and a lack of resolve toward fundamental tax reform were the primary factors that relegated taxation to a secondary role in Malaysia's development.

Tax Reform

In the future, Malaysia will need to undergo major tax reform. To buttress its future development, it will need to raise substantial additional tax revenue to match its high expenditure needs—for renewed capital expenditure, as well as for maintenance and building infrastructure. These needs have been contained in past years to reduce the large fiscal deficit.[9] The practice of piecemeal tax changes to meet immediate revenue needs will have to be replaced by more structural tax reform.

If Malaysia's experience has demonstrated that it is best to avoid a tax structure made complex by multiple objectives, it should aim at a simpler system. If its system of tax incentives has not worked in the past, it is unlikely that it will work in the future. Instead, it could strive to broaden the base of its sales tax, which already operates on a limited value-added basis. It could consider imposing a property tax such as in Singapore, or introducing taxes on land speculation such as in Taiwan and as proposed in Korea. It should also aim at improvements in the administration of income taxes, together with a broadening of the income tax base.

2.2.6 Indonesia

Much has been written on Indonesia's pre–and post–tax reform experiences (Booth and McCawley 1981, Asher 1989, and Gillis 1990, among others). Here we endeavor to examine the nature of arguments as to why the simplification of Indonesia's tax system is considered successful. In this section, the background for the need for the whole reform effort is considered. Subsequently, the nature as well as the results of the reform is assessed.

Structural Characteristics

Indonesia is the second oil exporter in our sample. Like Malaysia, its tax system lingered in the shadow of revenues from petroleum and gas till 1985 when Indonesia began to implement one of the most comprehensive tax reforms in Asia. The task of reforming the tax system was difficult because the

9. Thus, Asher, Salih, and Salleh (1990) point out that government expenditure in relation to GDP fell from 40 percent in 1981–85 to 31 percent in 1986–90.

existing system had become extremely complex, while collection was small (see table 2.3). Direct taxes were a combination of royalties, property, and income taxes, though they were all treated under the "income tax" nomenclature for foreign tax credit purposes. Progressive scales applied to both the personal income tax (5–50 percent) and the corporate income tax (20, 30, and 45 percent) and included exemptions and exclusions that were not implemented efficiently. Incentives, comprising tax holidays and investment tax credits geared toward regional balance, employment promotion, investment in target areas, and the like, abounded. The property tax, dating back to the 1600s and applicable to both urban and rural areas, was collected mainly from the latter and had degenerated to insignificance with ever-growing exemptions. Consumption taxes comprised a turnover tax, selected excises, and customs duties, each accounting for about 1 percent of GDP. The cascading turnover/sales tax was subject to rate differentiation (eight rates between 1 and 20 percent), resulting not only in distortions but also in evasion, and many items were also exempted. In addition, the sales tax element in exports required a complicated export rebate system.

There was a widespread belief that tax administration was very poor while evasion was widespread. Both evasion and corruption were stimulated by the complexity of the tax system. Only a fundamental reform could improve the situation.

A Distinguishing Feature

The most distinguishing characteristic of Indonesia's tax system, as in Malaysia, was its primary dependence on the oil sector for the bulk of its revenue. The benefits of the oil sector allowed a high rate of growth combined with low inflation rates. Thus, spurred on by oil revenues, Indonesia's real annual GDP growth as 7–8 percent in the 1970s up to 1982, and inflation was less than 10 percent except during the 1973 and 1979 oil boom years. This result was achieved despite a "decade of neglect" of physical infrastructure[10] and in the presence of a ratio of nonoil revenue to GDP in the 7–8 percent range throughout the period (see Gillis 1990, table 1). This low ratio was justified in the hope that oil prices would continue to remain strong. Eventually, and as a result of the fall in oil prices in the early 1980s, the authorities came to believe that the excessive dependence on the oil sector should be reduced.

Fundamental Tax Reform

Once Indonesia decided to undertake fundamental tax reform, it made large strides in that direction. The changes made were comprehensive and well planned: the necessary laws were passed in 1983; a unified personal and corporate income tax was introduced in 1984 at rates of 15, 25, and 35 percent; a

10. The problem of low expenditure for operation and maintenance remains significant (see Tanzi 1987).

uniform 10 percent VAT (coupled with higher luxury taxes) was introduced in 1985; and a new property tax aimed at urban real estate was introduced in 1986. Income tax–based incentives were abolished.

Indonesia's tax reform experience was clearly influenced by, and in turn it influenced, current world thinking. It was aimed at producing a much simplified system. Such a system would be neutral, that is, as nondistortionary as possible (few and low tax rates with no special incentives); equitable (taxation of urban property and luxuries pari passu, leaving low-income households out of the tax); and revenue-generating (though initially it was revenue-neutral, revenue was expected to rise rapidly from the broader tax base). However, the reform was less successful with respect to import duties. This is a problem that Indonesia will have to face during its next development phase as it attempts to modernize its industries while exposing them to adequate international competition.

It is generally accepted that Indonesia's tax reform has been successful in certain respects at least. First, it has reduced distortions caused by the previous tax structure. Second, its 1983–85 sales tax revenue of 1.5 percent of GDP has been doubled to 3 percent from the VAT (see table 2.3) in 1986–88, while excise revenue has been maintained. Third, administrative reform was a major objective in which initial gains seem to have been made.

2.2.7 Thailand

The last two countries in our sample—Thailand and the Philippines—are neither NICs nor oil exporters.[11] Within a decade, Thailand has increased its tax/GDP ratio by more than 2 percentage points of GDP. On the other hand, the tax/GDP ratio of the Philippines has stagnated in spite of that country's great need for revenue.

Structural Characteristics

Thailand has been a high-growth, low-inflation economy. It has undergone rapid economic transformation, as agriculture's share in GDP has been shrinking rapidly,[12] and as export promotion has replaced import substitution as a development strategy. However, Thailand's tax system has lacked the transparence that is needed to achieve specific objectives. If anything, it has been an obstacle to the achievement of those objectives.

The tax structure itself is complex. It has been characterized by base erosion resulting from many special allowances and high standard deductions (allowed for different sources of income) and by the failure to tax fringe benefits. Also, there are many nonneutralities in the tax treatment of different income sources on different transactions. In the corporate income tax, the differential tax treatment of interest and dividends has led to a bias in favor of

11. Given the high growth rate in Thailand in recent years, it may soon establish a claim to be classified as a NIC.

12. For a treatment of sectoral changes in GDP, see Richupan (1990).

debt financing, while asset revaluation formulas, loss carry-forward provisions, and the like do not appear to be internationally competitive.

Selected Distinguishing Features

Heavy Reliance on Domestic Consumption Taxes. Table 2.3 shows that Thailand has historically depended heavily on domestic consumption taxes and continues to do so—obtaining more than half of its tax revenue from a cascading business tax, applied with differentiated and high rates, and from a large number of excises (table 2.1). Customs duties and income taxes yield above a fifth each. Customs tariffs are also very complex, providing a wide range of effective protection to some domestic industries. The overall system of business tax, excises, and customs tariff has formed a complex, distortionary wedge into the production structure of the economy.

The Role of Tax Incentives. Thailand's Board of Investment played a major role in the allocation of the nation's productive resources by encouraging specific sectors and discouraging others through the tax system. The high degree of discretion and selectivity in the granting of incentives for a wide range of objectives, accompanied by little monitoring or follow-up of promoted enterprises, paralleled the experience of Indonesia and the Philippines. Indonesia's solution was to abolish tax incentives altogether. Thailand, like the Philippines, does not appear to have come to that solution.

To conclude, Thailand's tax structure is likely to have generated production distortions, with an adverse impact on production patterns and levels. This has been especially true of its business tax. In this sense, it may have sacrificed some of its potential growth over the years. However, its incentives regime, while complex and distortionary in conception, was even more deficient in implementation.

Tax Reform

Like Malaysia, Thailand has tinkered with its tax system over the years without any major policy reform. In 1989, it introduced further tax changes aimed at simplification, neutrality, and revenue generation. The personal income tax brackets were reduced from eleven to six, while the top rate remains at 55 percent. Also, a greater number of low-income taxpayers were left out of the income tax net. But, to address the revenue objective, a further schedular aspect was introduced with a withholding tax of 15 percent on dividend income. Not much has been done, however, to reduce expense deductions and allowances from business incomes.

The major tax reform under consideration by Thailand is the introduction of a 10 percent VAT to replace the current complex and inefficient business tax with twenty-one rates ranging from 0.10 to 50 percent. While several service activities and agricultural products would be left out of the tax net, this

would be a change in the right direction that can only benefit production and growth. While the combined changes in the system of excises and the business tax are to be revenue-neutral, the expectation is that the broad-based VAT would be revenue-enhancing in the medium term. Thailand has been getting ready for the introduction of the VAT. Much of the preparatory work has been done, and an intense campaign to instruct taxpayers has been carried out. However, it appears that some political hurdles must be overcome for the VAT to be introduced in Thailand.

Thailand will need to focus on reducing the wide dispersion of its nominal tariffs—thirty-four rates ranging between 1 and 200 percent—and the excessive rates of effective protection if it wishes to modernize its industrial sector. There is much discussion on this issue and many studies. The next step would be to place it firmly on the tax reform agenda. As in Taiwan and Korea, its current balance-of-payment situation does not justify the continuation of obstacles to import.

Finally, it should be mentioned that there have been major improvements in tax administration in recent years. In this sense, the experience of Thailand is different from that of the Philippines, with the public finances of Thailand having improved considerably in recent years. These improvements have made possible the rise in the tax/GDP ratio and have thus insured that at least the revenue objective was satisfied.

2.2.8 The Philippines

In our discussion of East Asian economies, placing the Philippines at the very end has a certain purpose: it has lagged behind in economic development and has had little success in applying fiscal instruments—both tax and expenditure—to promote its development needs. Furthermore, the quality of its tax administration has been particularly disappointing.

Structural Characteristics

The Philippines' shares of various taxes in total tax revenue parallel those of Thailand. However, while there has been a steady—though slow—increase in Thailand's tax/GDP ratio over the last decade, the Philippines' tax ratio has not increased beyond the low level of 11 percent (table 2.3), which occurred during a period when expenditure increases were significant. The consequence was a continuous fiscal crisis. Despite the recognition, in a number of studies and reports since the mid-1970s, of a need for major tax reform, the period through the first half of the 1980s witnessed only minor ad hoc changes in the tax system.

Changes in excises—especially in petroleum products—sales tax, and trade taxes were among the minor ad hoc revisions made. These changes made the system more complex and the administration more unwieldy. For example, domestic consumption was taxed by a "manufacturers' sales tax" on a value-added basis; a "contractor's tax" on some services while other individ-

ual services were taxed at differing rates; "fixed and graduated fixed taxes" on sales establishments, with rates varying according to business; and variously rated sales taxes on imports of domestic consumption goods that were designed to selectively provide protection to domestic production.

Income taxes also went through various revisions. For example, in 1981 the tax base was changed from net to gross income, and separate rates and exemptions were applied to different sources of income. These changes had the objective of improving revenue performance through easier administration. However, their impact on revenue was disappointing. Table 2.3 reveals that the income tax/GDP ratio as well as the individual income tax/GDP ratio both declined steadily in the post-1981 period. The same occurred to other taxes during the first half of the 1980s. This should not be surprising, since fiscal incentives—incorporating a basic 1968 legislation—covered a wide variety of objectives such as import substitution, labor-intensive production, and a well-ranked set—pioneer, nonpioneer (but preferred), and others—of industrial as well as export promotion. Further, instruments used were not just income taxes, but domestic sales taxes as well as customs tariffs.

Selected Distinguishing Features

Behind the stagnancy in the Philippines' tax effort lies a decline in its tax/GDP ratio between 1978 and 1985, and then a steady rise back to the initial level by 1988. The decline followed by the rise is reflected across domestic consumption and income taxes, though not trade taxes. Within these tax groups, the composition has changed: thus general sales taxes have remained at a much lower level than in the 1978–80 era, as has the individual income tax, whose fall has been countered to some extent by selective excises and by the corporate income tax. But the overall pattern that emerges is that, while up to the mid-1980s the tax system had ceased to be buoyant, in the second half of the decade it began to respond somewhat to the reform actions. However, the effort barely brought the tax/GDP ratio back to the level at the beginning of the 1980s.

Despite the large number of studies by international agencies and national bodies, there has been limited action by the authorities to implement serious tax reform. Administrative improvements have also been lacking. The authorities have made frequent use of tax amnesties. Between 1972 and 1981, ten amnesties were declared, yielding substantial revenues and, in effect, validating the failure in tax administration. The 1983–84 economic crisis spurred some action on reforming the tax system and on improving its tax administration.

Tax Reform

Tax reform in the Philippines became a major concern after the 1983–84 economic crisis. That concern accelerated with the 1986 change in government. The new government announced the intention of introducing basic

modifications to the tax structure to simplify it, make it more neutral, broaden its base, and raise additional revenue. Several tax measures became effective beginning in 1988.

A uniform 10 percent, consumption-based VAT was adopted. Capital equipment, agricultural inputs, and small businesses are exempt, while certain services such as hotels and insurance are taxed outside the VAT system. However, the performance of the VAT has not been too encouraging, and its revenue in relation to GDP has registered little increase over the pre-VAT years. One reason that has been cited is lack of administrative preparation and poor implementation (Sicat 1990). Unlike Indonesia and Korea, where administrative aspects received careful attention and the revenue response was far more positive, in the Philippines administrative aspects have continued to receive inadequate attention. The excises—mainly tobacco, alcohol, and energy products—have scored better in revenue response.

The Philippines abolished all export taxes—on copper concentrates, sugar, copra, and coconut oil—except those on logs and lumber. While highly desirable from an efficiency and, perhaps, equity perspective, this change led to a loss of a steady source of revenue that the country was not able to replace easily with alternate sources. The schedular income tax system was continued, while the number of individual income tax rates was reduced and the top rate was halved to 35 percent. The base was broadened to a "modified gross"—from the earlier "net"—base system. The top individual and the corporate income tax rates were aligned.

So far the revenue response to these changes has been marginal. This had been expected for the individual income tax—a result exacerbated by the tax exemption of dividend income from 1989—but not for the corporate income tax. For the latter, it had been assumed that tax evasion would be reduced as a result of the introduction of a single corporate tax rate. The tax incentive system was again tinkered with and, possibly, made more ample and unnecessary (Sicat 1990). Finally, a tax amnesty was declared (in 1986), yielding about 3 percent of income tax revenue.

To conclude, the Philippines has introduced various tax reform measures in the late 1980s, comprising income and consumption taxes. Yet the revenue response has so far not been significant. Clearly, the Philippines is one case in which taxation will be ineffective unless major administrative improvements are made.

2.3 Lessons and Conclusions

We have discussed some important features of the tax systems of eight East Asian economies. These eight countries include some very successful economic performers—Hong Kong, Korea, Singapore, Taiwan, and Thailand; some adequate performers—Indonesia and Malaysia; and one that has had substantial and continuous economic problems during the past decade,

namely the Philippines. This characterization is made on the basis of growth rates, rates of inflation, balance-of-payments performances, and whether external debt became a major problem.

The question that must be asked now is whether there are any lessons or general conclusions that could be drawn from the experiences of these economies. We will discuss separately conclusions relating to economic performance in general and conclusions derived from the earlier discussion of the tax systems.

2.3.1 Lessons from Economic Performances

Tax policy is only one element of the general economic policy pursued by a country. Other policies, such as fiscal policy in a broader sense, monetary policy, exchange rate policy, price policy, and the various regulations that often greatly influence the allocation of resources, are equally important. It is thus difficult to isolate the effect of tax policy from that of the other policies or to attribute to it economic successes or failures. The countries that performed well generally pursued good policy on many fronts. They did not allow the real exchange rate to become overvalued, they did not allow large and difficult-to-finance fiscal deficits to arise, and they pursued monetary policies that kept inflation under control and real interest rates positive. In fact, in some of these countries, tax policy would not have deserved particularly high marks if assessed in isolation.

By and large, the successful countries avoided difficulties with external debt. They did not borrow to finance consumption or unproductive investment as happened in some other Asian countries (see Tanzi 1987) and in too many countries elsewhere in the world. In Korea and Thailand, the growing size of the external debt became a concern in the early 1980s, and both countries took steps to bring down their ratio of external debt to GDP. In Malaysia, the external debt became a greater concern, having reached a very high ratio of GDP. In more recent years this country has also been attempting to control that problem. In the Philippines, however, the external debt has continued to grow, creating major difficulties for policymakers. In Indonesia, the external debt has been a continuous concern, although it has not created the same difficulties as in the Philippines.

In all of these successful countries, the government has played a major role. Therefore, the hypothesis advanced by some writers, that the success of some of these countries was due to the insignificant role of the public sector, is simply not correct. What is important is that the government's role was limited to its traditional functions, namely, the provision of social and economic infrastructure, the maintenance of a stable economic framework, and the promotion of growth. The signal that the government gave over the years was that increasing the size of the economy, especially through the stimulation of exports, was more important than the redistribution of income or the achievement of special social goals. Public expenditure was mostly of the type that

public finance experts sometimes call "exhaustive"—in other words, it directly used goods and services. Education, in particular, received a lot of attention. In this area, these countries outspent most other developing countries. Furthermore, education was oriented toward technical fields. The proportion of transfers in total expenditure was kept small. The role of social security in these countries, with the exception of Singapore, was limited. And welfare transfers were almost nonexistent. Government jobs were generally well paid and carried prestige. Public employees were a powerful group. Clientelism and unemployment reduction did not play any significant role in the selection and hiring of government employees.

In summary, the public sectors in the successful East Asian countries were consistent with the view that public sectors should be small but efficient. In the less successful countries of the sample, some of the above conditions did not exist.

2.3.2 Lessons from the Tax Systems

A few lessons can be derived from the analysis of the tax systems of the sample countries. First, the importance of the *structure* of taxation is directly related to the stability of the macroeconomic framework. The more stable the macroeconomic framework, the more important becomes the tax structure. The tax structure may become largely irrelevant when macroeconomic problems become predominant, and the distortions created by the tax system become of a second order of magnitude. In these situations, it may be preferable to raise the level of taxes through "bad" taxes, in order to reduce the fiscal deficit, than to continue with a low-yielding but "good" tax system that does not generate sufficient revenue to cover expenditure. This conclusion rests on the assumption that raising revenue will necessarily help correct the macroeconomic imbalance by reducing the size of the fiscal deficit. It also implies that a poor tax structure is not itself a major contributor to the macroeconomic problems. However, a country that, for example, attempted to raise a large share of total tax revenue from export taxes might be contributing to its own macroeconomic difficulties by discouraging exports.

Second, there seems to be little relationship between fiscal disequilibrium and the level of taxation. The country with the highest level of taxation (Malaysia) was also the one with the highest fiscal deficit. On the other hand, the two countries with the lowest level of taxation (Hong Kong and the Philippines) included one of the best and the worst economic performers in the group. In this connection it may also be important to ask what countries attempt to achieve with the resources they collect from higher levels of taxation. Why do countries aim for widely different tax levels and expenditure levels? In Malaysia, for example, the level of public spending reached 40 percent of GDP in the early 1980s, while in several of the other countries it was one-third or half that level. Why did Malaysia feel the necessity to bring its public spending to such a high level while, say, Taiwan and Thailand did not? Were

there specific objectives (literacy, life expectancy, employment, a better income distribution) that Malaysia was trying to achieve? Was it successful? The experience from developing countries in general also indicates that raising taxes, without controlling nonproductive public spending, often leads to disappointing results.

Third, no clear pattern of tax policy appears among the five most successful countries. None had particularly high tax ratios, and two of them, Singapore and Taiwan, made good use of property taxation, a distinctive feature of these countries. In fact, there is no comparable experience in the developing world. Korea is contemplating following this experience by introducing property taxes to discourage speculative investment in land. The reliance on income taxes was also varied. Some countries had very low income tax rates on both individuals and enterprises, but others did not. In general income tax rates were not particularly low in these countries, except in Hong Kong.

Hong Kong is the classic example of a Reagan-type supply-side economy. It has a small but highly efficient government that has given no role to government bureaucrats in the selection of investments, a decision left essentially to market forces, and has used low tax rates applied to broad bases. Thus, Hong Kong went for the leveling of the playing field long before such an approach became fashionable. In fact, the Hong Kong experience inspired some of the early and influential writers on supply-side economics. Furthermore, the tax environment for investors and decision makers in general was quite stable, since tax rates were kept essentially unchanged over decades and the structure of taxation was left intact over many years. Thus, the playing field was not just leveled across investments at one moment of time but also over time. These low rates were assumed to stimulate high savings and to encourage the use of that saving in the most productive activities. The country did not discriminate between domestic and foreign investment. The government saw its role as that of providing a low-cost and stable environment for potential investors, whether domestic or foreign. This attitude left no role for explicit tax incentives. Given the transparency of the tax system, it probably also left little, if any, role for rent-seeking activities. One would assume that Hong Kong would provide a good model for other countries to imitate. In fact, it has often been considered by supply-siders as the ideal model.

The problem with the above conclusion, however, is that Taiwan followed a very different strategy but achieved similar results. Taiwanese policymakers believed that they could pursue an investment strategy that would second-guess the market and pick winners. As a consequence, Taiwan kept its tax rates much higher than Hong Kong but pushed the investors in the desired direction through the widespread use of tax incentives. These incentives were fine-tuned to a degree rarely seen in other countries. Through tax incentives the government tried to encourage exports as well as investment in high technology industries. At the same time it tried to discourage investment in "unproductive" expenditure through high income tax rates and high land taxes.

This strategy is a challenge to the kind of supply-side economics identified with Hong Kong.

On the basis of the experience of many developing countries, many tax experts are now strongly opposed to the use of tax incentives. These are seen to breed corruption and rent-seeking activities and to negatively affect the quality of the tax system. And often they are also seen to be ineffective. Yet Taiwan has grown at a very high rate and has promoted high technology industries presumably through the use of tax incentives.[13] And, to a large extent, Korea and Singapore have done the same. Was there something peculiar to these countries that made possible for them the productive use of instruments that are largely discredited and ineffective in other countries?

One possible answer is that the effectiveness of the tax incentives may depend less on their own characteristics than on the characteristics of the countries where they are used. In countries where the public bureaucracy is made up of a well-paid, well-trained, powerful, and respected elite and where the population is highly homogeneous and deeply committed to achieving particular social goals, the use of tax incentives will not lead to the same detrimental influences often found in other countries. Korea, Singapore, and Taiwan are clear examples of the former type of countries. There is no doubt that they are highly homogeneous and that their civil servants represent a powerful and efficient elite. In these countries, civil servants can use the incentives and other policy instruments to push economic decisions in directions that give more weight to longer-term results than to immediate results and that may generate important externalities that facilitate the growth process. In other words, the decision-making process of the public bureaucracy may be guided by a lower, implicit, discount rate than the one that guides the private sector.

Private enterprises are likely to make economic decisions on the basis of current relative prices and factor availability. In other words, they tend to focus on immediate and private profits. Or, putting it differently, they make decisions on the basis of a static concept of comparative advantage or efficiency. However, a dynamic society, especially at an earlier stage of development than industrial countries, might be able to pursue policies aimed at changing the current comparative advantage and at exploiting externalities. This line of argument has been developed recently by Murphy, Shleifer, and Vishny (1989), Romer (1989), and others. Government bureaucrats might believe that, with proper policies, including tax incentives, costs of production can be reduced by increasing the factors of production that are now scarce. This is a kind of infant industry argument, but applied to the whole society rather than to a specific firm.

For example, if the incentive legislation favors technologically advanced activities, this (1) will signal to the investors that the government will generate

13. Of course, an open question is what would have happened in the absence of those tax incentives.

a desirable habitat in those activities in more ways than just through tax incentives,[14] (2) will stimulate investors to search for and acquire the relevant technology, and (3) will signal to individuals that education in technical fields will be well compensated.[15] In other words, the tax incentives may have a kind of announcement effect that, in time, will change the comparative advantage of the country.

Let us outline a bit more precisely the role of tax incentives and related government policies in Korea, Singapore, and Taiwan. This role can be assessed in the spirit of recent growth theories. The starting point must be the identification of a precise and broadly shared goal of economic policy. In these countries that goal was undoubtedly the stimulation of technologically based export industries. The promotion of that goal was pursued through educational expenditure and the provision of incentives. A sound macroeconomic framework was the essential background. A facilitating factor was a relatively good initial income distribution, which at least for a while reduced social tensions while at the same time enlarging the size of the domestic market for the goods produced.

As already mentioned, public expenditure for education was much higher in these countries than in the majority of developing countries, and education put a lot of emphasis on technological fields, especially on engineering. The brightest students could also get scholarships to do advanced work in foreign schools, especially in foreign engineering schools. The effectiveness of educational spending by the public sector was enhanced by the attitudes of parents. The latter came to believe that the road to success for their children was through education. This promoted an extraordinary competition among the students to get into good schools. Hard scholastic work became the norm.

The widespread technical knowledge among the population created a fertile ground for the transfer of technology from more advanced countries. It also created a fertile ground for the diffusion of that technology within the country. Having started far behind the industrial countries, these countries did not have to generate new technologies themselves but could go a long way by adopting (often with important modifications) technologies that were easily available in advanced countries. They started with simpler technologies (i.e., textiles, shipbuilding, steel) and progressively moved toward more sophisticated ones (electronics, computers).[16]

While education created the ground for the absorption of these technolo-

14. This may signal that that particular habitat will benefit from credit availability, provision of relevant information, and favorable regulations. Furthermore, educational expenditure of the right kind can make that habitat more attractive.

15. This may explain why American engineering schools have been very popular with students from these countries.

16. To quote from Romer (1990, i, 10): "Technological advances generate benefits that are at least partially excludable. . . . This means that . . . nonconvexities matter for growth . . . [and] matter for aggregate level analysis . . . there are large dynamic gains from trade between similar countries."

gies, tax and credit incentives were used to guide investment by specific firms toward particular areas. The assumption was that these were the areas that provided the best chances for future exports. In part the incentives may have compensated the specific firms that benefited from them for the positive externalities that they generated by being the pioneers in some areas. The diffusion of technology may also have been facilitated (especially in Korea) by the financial relations among enterprises (i.e., by the conglomerates).

2.4 Concluding Remarks

In the previous section, we have discussed the (probably) beneficial effects of incentives in Korea, Singapore, and Taiwan. It must be reiterated and emphasized that these were rather unusual experiences. The beneficial effects of incentives will not take place if incompetence, corruption, or various forms of rent-seeking activities become important. In such cases, incentive legislation, especially if based on discretionary decisions, will provide a perfect instrument for enriching some bureaucrats and for permitting some investors to evade paying taxes. The loser would be the public interest. Therefore, the experience of our successful countries is not necessarily transferable to other countries. Even in our successful countries, these incentives will eventually outlive their usefulness. It will become progressively more difficult to pick up winning industries as these countries develop. Furthermore, if the tax incentives are successful, they will make some individuals very rich. If these individuals adjust their consumption standards in line with their incomes, social inequities will become apparent and social tension will rise. This will bring to the forefront the objective of a fair income distribution (see Murphy, Shleifer, and Vishny 1988). The tax system will be seen as an instrument that can be used to achieve this objective. Tax reform should then be aimed at reducing conspicuous spending and high incomes. Wealth taxes and more equitable income taxes can be efficient instruments to achieve these objectives.

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Comment Joseph Y. Lim

The paper is a nice summary of the tax policies, experiences, problems, and future prospects and directions of tax reforms in East Asian countries. I particularly like the section on the lessons that can be learned from these countries, and I will concentrate my comments on this part later. However, there is hardly any discussion on the effects of tax policies of East Asian countries on one another, or their interdependence. This is particularly true for the ASEAN countries, since these countries are mainly competitors with respect to exports and foreign investments and they are increasingly dependent on trade relations and foreign investments from Japan, Taiwan, Korea, and Singapore. Yet they desire regional coordination and cooperation. Therefore there is a need to ask if there is room for regional harmonization or mutual cooperation in tax policies. This important aspect seems to have been left out in the paper.

Having said this, let me turn the discussion on the lessons learned from the experience of East Asian countries. What I will say will just be additions to what was said by Vito Tanzi and Parthasarathi Shome. In a way it tries to explain why countries with very different fiscal policies may succeed in an export-oriented path and is also a sort of apology as to why the Philippines is the basket case in the paper's list of countries. In another sense, this is not really an apology, since I will be quite harsh on the Philippines.

At this conference John Whalley posed the question of how issues on tax policies and reforms qualitatively differ between a developed and a developing economy. From the Philippine point of view, this is a very important question indeed. To answer it, we will have to go deeply into the heart of political economy—a most relevant topic for our conference.

It is fortunate that in public finance, especially in recent times, the literature has taken into consideration the hard realities—particularly the importance of the government, the nature of the state, and implicitly the level of social cohesion of the country being analyzed—in tackling fiscal problems.

I remember the old days when I was an undergraduate taking up my basic economic course; fiscal policies were important, not only because they had some effects on the multiplier, but also because all questions pertaining to equity were regulated to the fiscal solution. I simply imagined the Philippine state and was puzzled how this could be done. Would the powerful landlords and monopolists in the executive, legislative, and judicial branches miraculously tax themselves and provide transfer payments to the poor and needy? Surely the realities of our neighbors in Japan, Taiwan, and South Korea have shown that wealth and income redistribution of a backward society like ours was most effectively tackled through a radical agrarian reform, high investments in human capital and education, and other structural transformations rather than through fiscal policies of a rent-seeking state.

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Most recently we Filipinos again have been told by textbooks—by way of some pseudo-supply-side arguments—that low tax rates or tax incentives and tax credit should be given to foreign investments without any consideration to the government's responsibility of providing economic and political stability, proper infrastructure, and profitable environment to the investors. Indeed we have given four-to-six-year tax holidays, enormous tax credits (many are distortionary since they exempt capital goods importation in a labor-abundant economy), and even subsidized foreign investments through the debt-to-equity swap scheme (which converted debt papers to equity investments at a 50% discount). Our incentive scheme for foreign investments is (especially if you include the debt-to-equity swap) better than other ASEAN countries. But the foreign investment did not come in a massive scale as it did to our ASEAN neighbors. Much of foreign investment that came in 1986–88 was due to debt-to-equity swaps. Some that came in were fly-by-night investments or investments running away from regulatory restrictions (e.g., strict environmental laws) from other countries. The Philippines lost at least $4 billion of annual revenues from investments that would have come in anyway (the attractive debt-to-equity arrangement saw to it) at a time when we faced extreme fiscal constraint wherein almost 50% of the budget was and is going to debt service (two-thirds of which is domestic debt servicing and the rest foreign debt servicing).

Again we were taught by the textbooks and by the International Monetary Fund and World Bank to practically abolish restrictions on capital outflow as part of the liberalization process, and we did so in the early 80s. But as the paper of Assaf Razin and Efraim Sadka reminds us, this was done without consideration of the country's capability to tax its citizens and firms abroad or to run after runaway capital. So that when economic and political crisis struck in the second half of 1983 (partly caused by the assassination of Benigno Aquino), much evidence showed that capital flight was indeed facilitated by the above scheme.

The Philippines has also done everything a good "boy" should do in the field of tax legislation. The 1986 reform included

1. a movement from schedular to global income taxation,
2. a unification of withholding taxes on interest income and royalties,
3. an elimination of withholding tax on dividends,
4. unification of corporate income tax at 35%,
5. initiation of value-added taxation to replace the cumbersome sales-turnover tax,
6. abolition of export taxes except on logs, and
7. supposed general revision of valuation of real property for tax purposes.

Most of the above (except 3 and 6) were done partly with the goal of increasing government revenue. But now about four years later, our tax/GDP ratio is back only to the prerecession level of the early 1980s, which is around 12%—the lowest in the whole ASEAN region. Because of this poor fiscal

showing, Congress has just legislated more taxes on "sin" products (e.g., alcohol and cigarettes). The cabinet has proposed a tax package containing a supposedly progressive scheme on additional taxation of property and nonessentials. The Speaker of the House of Representatives, who (perhaps until this week) is the leading presidential candidate in 1992 representing Aquino's ruling party, opposed the scheme, stating "The rich have to be protected."

Now the IMF is asking us to cut our budget deficit. If we cannot increase tax revenues significantly, which is certain, we will have to cut back on our government expenditures—particularly capital outlays—at a time when the country's infrastructure is deteriorating and the economy is racked by a perennial power shortage.

All of these are related to Tanzi's and Shome's point about the importance of the government and why countries with opposite policies—one using the nonintervention approach (Hong Kong) and others more interventionist (Taiwan, Korea, Singapore)—can all succeed due to the existence of (what I call a) "good" government, i.e., a forward- and long-term-looking, stable, and continuing government with a broad professional bureaucracy serious about attaining a national goal. The Philippines is the other side of the coin; it had a "bad" government epitomized by the Marcos government, which bred corruption and rent seeking (in tax administration, among other areas), combined with various inefficiencies and ineptitude in the bureaucracy. Many critics of Aquino claim that the government has not yet changed. Even the reasonable Aquino supporters admit that the political will and the government's capability to institute radical change is gone. And the social cohesion necessary for a successful transformation to be effected without chaos and anarchy is lacking. The Aquino government also cannot guarantee that whatever policies in effect now will survive 1992 when the Aquino government gives way to its successor.

Implementing fiscal reforms and, as Tanzi and Shome correctly point out, most other economic reforms (trade, industrial, financial) requires a "good" government. This may even accommodate interventionist policies. For the new developments in institutional economics have shown that if there are market imperfections (high transaction costs or market failures), if there is opportunism and asset specificity (to quote Oliver Williamson), then there is need for strong governance. A "good" government, therefore, free of rent seeking, can indeed use interventionist policies to achieve an economic goal, especially if it is supported by the economic agents.

Cooperative and repeated game theories show that, in a prisoner's dilemma type of situation, cooperation rather than individual optimization may yield a higher social utility. Indeed social cohesion and good and responsible government are needed for economic reforms—one of the most obvious being fiscal reform.

It is important then that when talking about fiscal reforms, a concentration on "correct" fiscal policies (which may remain on paper only) without looking

at the institutional factors may be misleading and even detrimental, as the Philippines illustrates. It is high time that economists descend from cloud nine and accept that which every man in the street already knows—policy prescriptions and reforms do not exist in a vacuum. Perhaps more important may be the institutional setting and environment wherein these policies and reforms will be undertaken. And I think this is the single most important lesson that we should learn from the Tanzi-Shome paper.